Part 1

INTRODUCTION TO ECONOMICS

ECONOMICS

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WHAT IS ECONOMICS?

I. The Economy and Economic Systems

Exchanges

In the economy we are faced with many decisions, many involving an exchange sometimes using money as the medium.

- Households purchase final goods and services for final consumption and also provide the inputs into production – land labour and capital.
- The organizations which buy these factors and use them to produce goods and services are referred to collectively as firms.

The Economic Problem

The three big questions are:

- What goods and services should be produced?
- How should it be produced using combinations of land, labour and capital?
- Who should get the goods and services produced?

Scarcity and Choice

Society and Scarce Resources:

- The management of society's resources is important because resources are scarce.
- *Scarcity* means that society has limited resources and therefore cannot produce all the goods and services people wish to have.
- *Economics* is the study of how society manages its scarce resources.

II. How People Interact

Different scales

'*The economy*' refers to all the production and exchange activities that take place every day - all the buying and selling.

The economy exists at different scales:

- Local
- National e.g. the UK
- International e.g. EU

People Face trade-offs

To get one thing, we usually have to give up another thing.

- Food v. clothing
- Leisure time v. work
- Clean environment v. higher incomes
- Efficiency v. equity
- *Efficiency* is how society gets the most that it can from its scarce resources.
- *Equity* means the benefits of those resources are distributed fairly among the members of society.

Making decisions requires trading off one goal against another.

Opportunity Cost

Decisions require comparing costs and benefits of alternatives.

- Whether to go to university or to work?
- Whether to study or go out on a date?
- Whether to go to class or sleep in?

The *opportunity cost* of an item is what you give up to obtain that item. It is a ratio expressed as the sacrifice in one good in terms of the gain in the other.

Thinking at the Margin

- *Marginal changes* are small, incremental adjustments to an existing plan of action.
- *Economic agents*: an individual, firm or organization that has an impact in some way on an economy.
- *Being rational* is the assumption that decision-makers can make consistent choices between alternatives.

People make decisions by comparing costs and benefits at the margin.

People Respond to Incentives

Assuming rational people make rational decisions, then….

- Marginal changes in costs or benefits motivate people to respond.
- The decision to choose one alternative over another occurs when that alternative's marginal benefits exceed its marginal costs!
- Public policies can create incentives or disincentives that alter behaviour.
- Sometimes policymakers fail to understand how policies alter incentives and behaviour.

III. How people Interact

Trade Can Make Everyone Better Off

- People gain from their ability to trade with one another.
- Competition leads to gains from trading.
- Trade allows people to specialize in what they do best.
  - However, sometimes this leads to people losing their jobs as production moves overseas. They need alternative skills and the area needs to attract new investment, which does not always happen.

The Capitalist Economic System

- An *economic system* is the way in which resources are organized and allocated to provide for the needs of an economy's citizens.

- A *capitalist economic system* incorporates the principles of the private ownership of factors of production to produce goods and services which are exchanged through a price mechanism and where production is operated primarily for profit.

  - Critics of the capitalist system argue that they are inherently unstable and lurch from boom-to-bust and that owners of the factors of production are too powerful and can distort resource allocation.

Markets Can Be a Good Way to Organize Economic Activity

Pure market economy has no government intervention.

- It allocates resources through the decentralized decisions of many firms and households as they interact in markets for goods and services.

Market prices reflect both the value of a product to consumers and the cost of the resources used to produce it.

- Therefore, decisions to buy or produce goods and services are made based on the cost to society of providing them.

Planned Economic Systems

- A planned *economic system* is when economic activity organized by central planners who decide the answers to the fundamental economic questions.
- Most countries that once had centrally planned economies have abandoned this system and are developing more market-based economies.

FYI Adam Smith and the Invisible Hand

In 1776 Adam Smith made the observation that households and firms interacting in markets act as if guided by an "invisible hand."

- People are motivated by self-interest. Households and firms look at prices when deciding what to buy and sell.
- Prices guide decision makers to reach outcomes that tend to promote general economic well-being.

Governments Can Sometimes Improve Market Outcomes

Markets do not always lead to efficient or equitable outcomes.

- *Market failure* occurs when the market fails to allocate resources efficiently.
- When the market fails government can intervene to promote efficiency and equity.
- Market failure may be caused by:
  - an *externality*, which is the impact of one person or firm's actions on the well-being of a bystander.
  - *market power*, which is the ability of a single person or firm to unduly influence market prices.

IV. How the Economy as a Whole Works

Macroeconomics and Microeconomics

- *Microeconomics* is the study of how households and firms make decisions and how they interact in markets.

- *Macroeconomics* is the study of economy-wide phenomena, including inflation, unemployment and economic growth.
  - Changes in the overall economy arise from the decisions of millions of individuals, so macroeconomics and microeconomics are linked.

An Economy's Standard of Living Depends on its Ability to Produce Goods and Services

Economic growth - the increase in the amount of goods and services in an economy over a period of time.

Gross domestic product per head - the market value of all final goods and services produced within a country in a given period of time divided by the population of a country to give a per capita figure.

An Economy's Standard of Living Depends on its ability to produce goods and services

- *Standard of living* - a measure of welfare based on the amount of goods and services a person's income can buy.
  - Usually measured by the inflation adjusted (real) income per head of the population.
  - Most variations in living standards are explained by differences in countries' productivities.
- *Productivity* is the amount of goods and services produced from each hour of a worker's time.

Prices Rise When the Government Prints Too Much Money

- *Inflation* is an increase in the overall level of prices in the economy.
  - One cause of inflation is the growth in the quantity of money.
  - When the government creates large quantities of money, the value of the money falls.
  - High inflation imposes various costs on society.

Summary

① When individuals make decisions, they face trade-offs among alternative goals.

② The cost of any action is measured in terms of foregone opportunities.

③ People often make decisions by comparing marginal costs and marginal benefits.

④ People change their behaviour in response to the incentives they face.

Summary

⑤ Trade can be mutually beneficial.

⑥ Markets are usually a good way of coordinating trade among people.

⑦ Government can potentially improve market outcomes if there is some market failure or if the market outcome is inequitable.

⑧ Productivity is the ultimate source of living standards.

⑨ Money growth is the ultimate source of inflation.